

**Note for Special Meeting of
LegCo Panel on Financial Affairs
14 March 2002**

Anthony Rogers
Chairman
Standing Committee on
Company Law Reform

1. The views expressed in this note are personal views. Whilst it is intended that they should reflect the views and likely conclusions and recommendations of the Committee, because its work on corporate governance is by no means finished, the Committee's conclusion and recommendations are yet to be formulated. This note does not aim to provide a comprehensive review of all aspects at present being considered by the Committee but can only highlight a few of the matters and issues.

Background to Committee's work on corporate governance

2. On completion of the overall review of the Companies Ordinance, the Committee was asked to consider corporate governance. In order to do this, three subcommittees were formed with a view to considering matters relating to shareholders, directors and corporate reporting.

3. Last summer, July 2001, the Committee issued a consultation document setting out various proposals. In the main, these matters were items arising from the review of the Companies Ordinance. Matters relating to corporate reporting came, primarily, from proposals from the accountancy profession. Appendix B to the paper CB(1)1184/01-02(04) reflects the proposals which were put forward in the consultation paper last July. Those proposals have now to be viewed in the light of the responses to the consultation document and further consideration given to the matters by the Committee.

4. The response to the consultation document has shown that the business community is very wary of over regulation of private companies. As one example, the consultation document had proposed that private companies should file their annual accounts in the Companies Registry. That proposal has met with almost universal disapproval. In view of the points made in the responses, the Committee is now not proposing to recommend to the Secretary for Financial Services that such filing be introduced.

5. One major difficulty thrown up by the consultation has been in relation to directors' dealings with associated companies. The proposals in the consultation document in relation to this aspect did not meet with universal enthusiasm. The Committee has, however, determined that the matter should be considered again with a view to formulating appropriate proposals.

Commissioned research projects

6. The Committee has commissioned four research projects. City University was successful in respect of three tenders and Chinese University in respect of one. These cover the areas of investors attitudes; a comparative study of corporate governance regimes in other countries; audit, nomination and remuneration committees and finally an analysis of the extent of single family control and its effect on economic performance of the relevant companies.

7. There has been some delay in the provision of the final reports of these projects although current progress would indicate that the reports should be available by the end of April or soon thereafter.

8. One further research project has not been commissioned in view of the unsatisfactory tenders.

9. Some of the preliminary and tentative results which are emerging from these research projects include:

- (a) Investors, in particular institutional investors, are more concerned about track records and past performance of

companies than they are about corporate governance.

- (b) Although there may be a perception that corporate governance matters in Hong Kong were not as well regulated as in other jurisdictions, so far nothing specific has been shown where Hong Kong is lagging behind.

10. The preliminary conclusions derived from one of the research projects appears to be that it is the norm for Hong Kong companies to be controlled by a single shareholder or family. Often this is done with structures of holding companies, which, for want of a better expression are referred to as a pyramid structures. It would appear that this would be true of more than 80 per cent of the companies on the main board listing. This is higher than any other jurisdiction. Equally interesting, however, is that the results of the research are likely to indicate that family controlled companies are at least as successful as widely held companies. Indeed, those companies that have significant directorships and senior management posts held by members of the controlling family appear to be significantly successful.

Nature of Hong Kong listed companies

11. The prevalence in Hong Kong of single family control of listed companies is one factor which has to be taken into account in formulating proposals for corporate governance. Another special feature of the Hong Kong stock market is that 75 per cent of listed companies are incorporated overseas. This creates important attendant difficulties in that it is sometimes difficult to introduce legislative or other controls because of the extraterritorial considerations.

12. Although the Stock Exchange listing rules can be used in respect of corporate governance matters it has to be borne in mind that

- (a) Listing rules are primarily the province of the stock exchange which is a trading company.
- (b) Listing rules do not have statutory backing and it might be difficult to give listing rules statutory backing, since statutory,

and thus legally coercive, force would be given to rules made by a commercial organisation.

- (c) In any event listing rules would not cover public but unlisted companies.
- (d) Listing rules cover companies which for the most part are incorporated overseas and may have listings overseas in addition to the Hong Kong listing.

Directors dealings

13. One of the major areas which the Committee will be concentrating on in the next few months will be in relation to directors' dealings with the company, subsidiaries and associated companies. This is an areas where it is likely that abuses could more easily arise. The aim of any new rules would be to prevent unfair advantage being taken by directors of their position. Such unfair advantage could extend to appropriation of assets. Some of the matters that need to be resolved in formulating proposals include:

- (a) How the regulation is to be achieved e.g. by statute or listing rules.
- (b) How to formulate rules and regulations that would be effective in terms of not being open to easy circumvention and yet not be over restrictive. In this respect the control of transactions effected overseas is likely to be a matter of some concern.
- (c) The scope of the transactions covered needs careful consideration when it is appreciated that an "associated" company is not defined in legislation and is an accounting term. The real test is perhaps of one of quality i.e. the extent of actual control rather than an empirical test.

A suitable solution is not obvious. Nevertheless, the Committee has resolved to try to find a solution that can be put to the Secretary for Financial Services.

The Enron case

14. Until full details of the Enron case have emerged after investigations and inquiries, no comments on it can be authoritative, but the following preliminary observations might be made.

- (a) Dealings by directors with linked and associated companies appears to have been one of the problems.
- (b) The frequency with which those involved seem to have taken the 5th amendment would indicate that there were plenty of rules in place but that they have been breached.

Independent and other non-executive directors

15. In relation to corporate governance considerable importance is often attached to the appointment of non-executive and in particular independent non-executive directors. These persons clearly play an important role in any company. However, amongst matters which should be borne in mind in relation to independent non-executive directors are:

- (a) The definitions of independence and classification of directors as independent in some cases would raise questions as to whether such persons are truly independent.
- (b) In view of the fact that nearly all companies listed on the Stock Exchange in Hong Kong are single family controlled it can only be surmised that that control extends to the selection of the independent directors. Indeed, the scope of action of those directors may well be circumscribed.
- (c) The pool of suitable persons to be independent non-executive directors, in Hong Kong, may be limited because the pool of persons with experience as corporate directors who are available and willing to act as independent non-executive directors may be limited. Those involved in running family

controlled companies are unlikely to retire early.

- (d) It may be that the most that should be expected of independent non-executive directors for the bulk of companies in Hong Kong would be the bringing of expertise to the company which the company does not already have.

The future progress

16. It is expected that there may need to be a further consultation in respect of proposals arising from the Committee's work. It is hoped that the Committee's proposals on corporate governance can be put to the Secretary for Financial Services by the end of this year or soon thereafter.

(Anthony Rogers)
12 March 2002